Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-3723-00
RHGannon

date:

to: Manager, Group E:1115
Lancaster, PA
Attn: Michael T. Taibi, Revenue Agent
William Haas, Valuation Specialist

from: District Counsel, Pennsylvania District, Philadelphia

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subject: [redacted]
SMR Management Agreement and Option

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In his memorandum dated June 13, 2000, Valuation Specialist William B. Haas requested Field Service Advice as to whether the taxpayer ("[redacted]") should recognize income from the receipt of payments characterized as option payments pursuant to [redacted]s SMR Management Agreement and Option dated [redacted] (the "Agreement"). For the reasons stated below, we believe that any definitive answer to the questions posed by Mr. Haas should await further factual development.

FACTS:

[redacted] is a corporation engaged in providing radio service to customers in [redacted] Counties, [redacted]. [redacted] provides various kinds of radio service pursuant to licenses granted by the Federal Communications Commission ("FCC"). The FCC grants licenses for carriers like [redacted] to operate at various frequencies in various areas. For example, prior to the entering into the Agreement, [redacted] offered radio services in both the [redacted] MHz and [redacted] MHz ranges in its service area.

Services provided by [redacted] could include the use of radio antennas, land lines and ancillary items of radio equipment, including the radios themselves and repeater transmitters. [redacted] typically targeted farmers and other business users as potential customers.

We understand that, sometime prior to September of 1997, the FCC announced its intent to require holders of licences in the 800 MHz range to provide digital service as a condition of retaining their licenses. We further understand that the capital cost of converting to digital service was quite high; [redacted] claimed in its sales literature that the cost of doing so was prohibitive, and that it was necessary for small providers like [redacted] to contract with larger providers like [redacted] with the wherewithal to compete in the digital marketplace.

[redacted] and its subsidiaries ("[redacted]") had developed, some time prior to [redacted], the kind of digital communications network necessary to carry out the FCC's intent of requiring its 800 MHz licensees to digitize service. [redacted]'s digital technology incorporated both the special antennas and other equipment to provide digital radio service and the trunk or land lines to transmit radio signals. Sales literature describing [redacted]'s digital service advertised a hand held device capable of both communicating with other devices over the air, and with distant telephones over the telephone lines. In [redacted] of [redacted], [redacted] was in the process of acquiring rights to offer its digital service over a large portion of the United States and, so we understand, had either acquired rights to operate in the areas surrounding [redacted]'s [redacted] MHz service area or was about to do so. [redacted], who had acquired comparable [redacted] businesses in the surrounding areas, was the ideal purchaser for [redacted]'s business.

In the negotiations with [redacted], [redacted] initially sought as much as $[redacted] for its [redacted] licenses, based on [redacted] times its annual, projected earnings for the licenses. An initial allocation of this target purchase price was [redacted]% to equipment, [redacted]% to a covenant not to compete and the remainder to [redacted]'s customer list. During the ensuing negotiations, [redacted] claimed that, while the business was worth something in the neighborhood of what [redacted] was asking for it, [redacted] could not afford that much money up front, and, apparently, subsequent efforts were made to work out a plan satisfactory to both parties.

The plan ultimately agreed to by the parties is incorporated in the [redacted] Under the Agreement, [redacted] agreed to take over the management of [redacted]'s existing [redacted] MHz service (the "System"). In connection therewith, [redacted] had the right to integrate the System into its own digital wide area ("[redacted]") network at its own cost. In the event of integration, [redacted] and [redacted] would enter into [redacted]'s standard Independent Services Representative agreement, indemnify [redacted] from any claims arising from integration, and negotiate leases with [redacted] for any existing [redacted] sites it wished to use in its [redacted] network.

The Agreement further provided that if [redacted] elected to integrate the System into its [redacted] network and did not elect to exercise its option to purchase the System, [redacted] was to restore [redacted]'s System to its former analog mode by replacing any digital equipment installed by [redacted] with analog equipment comparable to the equipment in place at the time it entered into the Agreement, request cancellation of any of its FCC licenses or authorizations relating to the frequencies used by the System and within a [redacted] mile radius thereof excepting those in existence at the effective date and those that did not require a waiver of the FCC's short-spacing rules, and pay [redacted] a $[redacted] Footprint Reconstruction Payment.

[redacted] was to bear all expenses of operating the System during the term of its management, and was entitled to all revenues derived therefrom, less $[redacted] per year during the first [redacted] years of the Agreement and $[redacted] per year for the final [redacted] years.

The Agreement further provided that, in return for a cash payment of $[redacted] to be made within [redacted] days of the execution of the Agreement, [redacted] was to have the option to purchase the System from [redacted] for the sum of $[redacted] during the period of the Agreement ([redacted] years). The option further provided for aggregate continuation payments of $[redacted] per annum in the [redacted] and [redacted] years following the date of the Agreement, and similar payments in the annual amounts of $[redacted] in the [redacted] and [redacted] years. Each of the payments was to be made in semi-annual installments.

As "additional consideration," [redacted] agreed to transfer all of the equipment used by it to service certain UHF locations in [redacted]'s service area free and clear of any liens or encumbrances. Finally, the Agreement provided that, in the event the option lapsed or the Agreement was terminated for any reason, [redacted] would pay the taxpayer a "Footprint Reconstruction Payment" of $[redacted].

[redacted] and several of its officer-shareholders agreed to sign covenants not to compete, although no separate considerations was allocated to the covenants.

DISCUSSION AND LEGAL ANALYSIS:

Option payments are not included in gross income until the option lapses or the option's grantor is no longer obligated to sell (or buy) the optioned property pursuant to the option agreement. I.R.C. § 1234(b)(1), (2). See, e.g., Elrod v. Commissioner, 87 T.C. 1046 (1986). Unlike a contract of sale where the seller and buyer are respectively obligated to sell and buy, the holder of an option to purchase property has no obligation to do so. Here, the Agreement did not require [redacted] to purchase the taxpayer's [redacted] MHz business. Instead, it expressly provided that the taxpayer had the duty to sell the business to [redacted] at [redacted]'s option. It further provided for an additional payment in the event the option lapsed or the Agreement terminated for any reason.

It has long been held that while taxpayers are generally bound to the form in which they agree to cast their transactions, they cannot contractually prevent the Service from looking to the substance of the transaction and attacking it where it is determined that it has no basis in economic reality. See, e.g., Commissioner v. Court Holding Company, 324 US 331 (1945), Gregory v. Helvering, 293 U.S. 465 (1935). On the other hand, the courts generally respect a taxpayer's attempt to structure his transactions to avoid tax as long as "the thing that was done was the thing which the statute intended." Gregory v. Helvering, supra at 469. This ordinarily invites a factual inquiry to discern the true nature of the transaction under examination.

While there is no doubt that the Agreement resulted from good faith, arm's length bargaining, some of the terms contained in the Agreement are troubling. For example, while there is a covenant not to compete, no consideration is assigned to the covenant despite the fact that, in pre-negotiation planning, [redacted] apparently contemplated allocating as much as $[redacted] to such a covenant.

Second, while the Agreement contemplates the possibility that [redacted] would not exercise the option, and while provision is made for restoring [redacted] to the same position it occupied on the effective date of the agreement together with a $[redacted] "footprint reconstruction payment," there is no provision for a return of the customer list and other proprietary information obtained by [redacted] under the Agreement. If, as determined by [redacted] in its pre-negotiating planning, their customer base represented [redacted]% of the value of the business, and if the value of the business was in the $[redacted] range, it seems strange that the Agreement did not provide for a "return" of the customer list and a covenant, on the part of [redacted], that it would not compete with [redacted] for those customers or any other new customers obtained for the [redacted] business [redacted] was "managing" for [redacted].

Third, despite the fact that [redacted] had no legal duty to buy [redacted]'s [redacted] MHz [redacted] business, the fact that it contemplated setting up its [redacted] system in the [redacted] area, at a considerable cost, makes it difficult to believe that it would not exercise its option and that [redacted], [redacted] and everybody else concerned did not recognize this fact. At first blush, it is difficult to believe that the parties did not and that [redacted] was not economically compelled to exercise the option at some time or other. This is born out, to some extent, by statements made to our examining agents that [redacted] contemplates doing so at the end of the [redacted] year term.

SUGGESTIONS FOR FURTHER DEVELOPMENT:

It is clear that further factual development is both necessary and desirable before you determine that the Agreement should be recharacterized as an outright sale and the purchase price should be allocated among equipment, covenants not to compete and [redacted]'s customer list. Rather than provide a detailed list of questions and documents suitable for preparing information document requests, we suggest that further development be structured on the following lines:

1. Technical Information: This would include information describing the regulatory climate in effect during the period in question. For example, what rule did the FCC promulgate, if any, requiring [redacted] to "go digital" with regard to its [redacted] MHz [redacted] business. Was there any specific time requirements? Did [redacted] face a possible loss of its licenses if it failed to convert to digital service? Was it possible for [redacted] to allow the option to lapse resulting in [redacted]'s loss of its license, and then for [redacted] to apply for replacement licenses to remain in business in [redacted]'s historic service area? Would it be possible for [redacted] and [redacted] to compete in the same area after the option lapsed?

In this regard, you should consider the propriety of retaining a technical consultant to advise with regard to some of the above regulatory/technical matters. You might consult with the Utilities ISP staff with regard to this to ascertain how prevalent agreements of the type utilized here were utilized by [redacted] and other [redacted] providers during the period in question.

2. <u>Financial Information</u>: This would include information from which we could replicate [redacted]'s conclusion that its [redacted] business was worth $[redacted] in [redacted], including segmented P&L statements, projections, industry data and other documents relied upon by [redacted] and its consultant to arrive at the $[redacted] figure. In this regard, it would not be inappropriate to seek these items from [redacted]'s consultant, and to also seek information regarding [redacted]'s acquisition of similar businesses, particularly those serving areas surrounding [redacted]'s.

3. <u>Other Information</u>: This would include, among other things, statements made by [redacted] with regard to its intent to exercise its option and other items describing the course of dealing between the parties over the period following the effective date of the Agreement. What other business relationships did [redacted] have with [redacted]? What kind of revenues did [redacted] derive from the [redacted] business it managed from [redacted]? What kind of investment did [redacted] make in the [redacted] service area with regard to the digital [redacted] MHz [redacted] business? Did [redacted] increase the customer base? Did [redacted] participate in the effort to increase the customer base through the use of its own sales' personnel?

The above questions are only examples of the kinds of inquiries that would be helpful in determining whether an adjustment was appropriate and, if so, what kind of adjustment and how much. Note that some of these suggestions would entail third party contacts and, possibly, taxpayer inquiries regarding the possibility of resolving any issues raised by these facts at the examination level. In this regard, it would not be inappropriate to coordinate this matter with the Utilities ISP program sooner rather than later, both to obtain any guidance they can offer with regard with the difficult factual issues raised by these facts and to determine their interest in pursuing this case as a possible litigating vehicle should further factual development justify an adjustment.

CONCLUSION:

This concludes our advice and recommendation. Please feel free to call Special Litigation Assistant Richard H. Gannon at 215-597-3442 with any additional questions you may have. We are forwarding a copy of this advices to the Assistant Regional Counsel (Tax Litigation) and to the Office of Assistant Chief Counsel (Field Service) (CC:DOM:FS) for mandatory ten day post review.

RICHARD H. GANNON
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